State Notes

TOPICS OF LEGISLATIVE INTEREST

November/December 2007

School Aid Funding Formula: Further Closing of the School Aid Equity Gap

By Kathryn Summers-Coty, Chief Analyst

Between 1994 and 2000, the gap between the highest and the lowest school districts' per-pupil funding[1] narrowed from $7,532 to $5,454. Since 2000, however, the gap has narrowed only another $223, and, until the most recent budget process, no multiyear mechanism was put in place to continue closing the gap. Public Act 137 of 2007 provides appropriations for the School Aid budget for fiscal year (FY) 2007-08. Within this Act, a substantial policy change was implemented, restoring the formula that was in place until 2000, which will close over time a portion of the school funding gap.

Recap of Proposal A and the Equity Gap Before FY 2007-08

The March/April 2007 *State Notes* contained an article entitled, "Per-Pupil Funding Gaps and Equity in School Aid". That article provided historical information on the mechanism for school funding before Proposal A, how Proposal A changed school funding, and how the per-pupil funding gap has shrunk since Proposal A's implementation in FY 1994-95. Included here is a duplication of Table 1 from that article, updated to include FY 2007-08 amounts. In summary, the per-pupil funding gap before Proposal A's implementation stood at $7,532; by FY 2006-07, the gap had shrunk to $5,231. However, without a change in statute for FY 2007-08, no further shrinking of the gap would have occurred.

Public Act 137 of 2007 and a Return to the Gap-Narrowing Formula

The School Aid budget for FY 2007-08 was enacted in Public Act 137 of 2007. The most notable feature of this budget was the resurrection of the gap-closing formula used from FY 1994-95 through FY 1999-2000. This formula provides a "base" increase for all districts, and then gives more per-pupil funding to those districts below the "target" foundation allowance. When Proposal A was implemented, the "target" or basic foundation allowance was $5,000; districts above that amount received a flat per-pupil increase, and those below that amount received up to double the amount given to districts above, on a sliding scale. Over time, the $5,000 "target" grew commensurately with the yearly dollar increases provided to all districts, until FY 1999-2000, when all districts "caught up" to the target of $5,700 per pupil.

Under Public Act 137, a new target of $8,433 was established. This figure was chosen because it represents the point at which State funding supporting a district's foundation allowance ceases, and any per-pupil allowance above that amount must be paid for with local revenue. In school aid terminology, this is the point at which "hold-harmless" districts begin receiving their local funds. The $8,433 figure will grow over time (as did the prior basic or target), with the growth equal to the per-pupil increases given to districts whose foundation allowances are above that amount. Districts below that amount will receive more per-pupil funding than those above, and in that manner, the gap will narrow.

[1] Bloomfield Hills is the highest per-pupil funded district with a standard-sized pupil population. (Two districts with fewer than 10 pupils have higher per-pupil allowances.)

Table 1

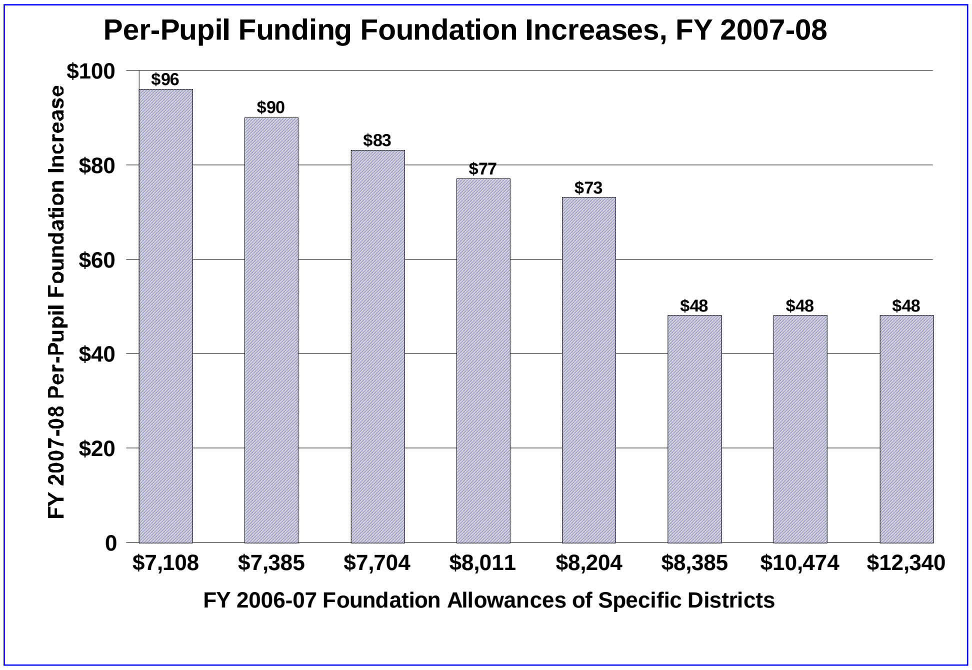
Foundation Allowance Changes Since Proposal A
FY 1993-94 through FY 2007-08

Fiscal Year	Minimum	Basic	Growth in Basic	Maximum[1)]	Equity Gap
1993-94	$2,762	n/a	n/a	$10,294	$7,532
1994-95	4,200	$5,000	n/a	10,454	6,254
1995-96	4,506	5,153	$153	10,607	6,101
1996-97	4,816	5,308	155	10,762	5,946
1997-98	5,124	5,462	154	10,916	5,792
1998-99	5,170	5,462	0	10,916	5,746
1999-2000	5,700	5,700	238	11,154	5,454
2000-01	6,000	6,000	300	11,454	5,454
2001-02	6,500	6,500[2)]	500	11,754	5,254
2002-03[3)]	6,700	6,700	200	11,954	5,254
2003-04[3)]	6,700	6,700	0	11,954	5,254
2004-05	6,700	6,700	0	11,954	5,254
2005-06	6,875	6,875	175	12,129	5,254
2006-07	7,108	7,108[4)]	233	12,339	5,231
2007-08	7,204	8,433	n/a	12,387	5,183

1) This maximum is for Bloomfield Hills, the highest per-pupil-funded district with a standard-sized pupil population. (Two districts with fewer than 10 pupils have higher per-pupil allowances.)
2) For FY 2001-02, the Basic Foundation Allowance was actually $6,300. However, a $200 per-pupil equity payment was subsequently built into the base for that year.
3) For FY 2003-04 and FY 2004-05, proration occurred; this did not statutorily reduce the foundation allowance, but reduced per-pupil funding by approximately $74 each year.
4) For FY 2006-07, the Basic Foundation Allowance was actually $7,085. However, a $23 per-pupil equity payment was subsequently built into the base for that year.

Specifically, for FY 2007-08, any district that in FY 2006-07 had a foundation allowance greater than $8,385 (i.e., "hold-harmless" district) is receiving a $48 per-pupil increase in FY 2007-08 (the sum of which brings the new target to $8,433). Any district that was at the minimum foundation allowance in FY 2006-07 (or $7,108) is receiving double the amount given to the hold-harmless districts, or $96 per pupil. For those districts with foundation allowances more than the minimum, but less than $8,385 in FY 2006-07, the increase being received in FY 2007-08 is something between $48 and $96, where lower foundation allowances generate higher per-pupil increases. Again, this is how the equity or per-pupil funding gap is narrowed. Figure 1 below illustrates a few specific examples, with varying district foundation allowances from FY 2006-07, and the per-pupil increase provided in FY 2007-08.

Figure 1



This inclusion in statute of a long-term gap-closing formula differs from the equity payments provided in two previous years. In FY 2001-02 and FY 2006-07, per-pupil "equity" payments of $200 and $23, respectively, were provided. Those equity payments were each one-year methods to close the gap, but were not long-term in the sense of setting a new targeted funding level. They also did not work on a sliding scale, where those districts at the bottom received more than those nearer the target.

Change in Charter School Formula

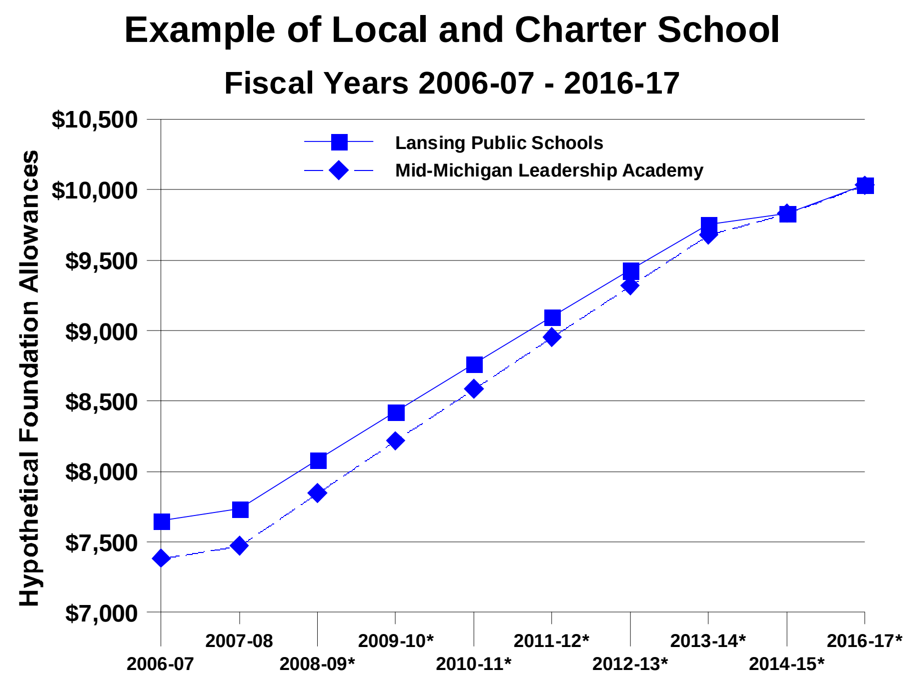
The resurrected formula provides a different manner of funding for public school academies (i.e., PSAs or charter schools) than in previous budget years. Until FY 2007-08, charter schools were allocated the lesser of the per-pupil funding of the local district in which the PSA was physically located or $300[2] above the basic foundation allowance. Beginning in FY 2007-08, however, the maximum per-pupil funding a PSA can receive is still capped, but the cap is no longer tied to the basic foundation allowance.

Instead, the cap reflects what the cap was in FY 2006-07, increased over time pursuant to the resurrected gap-closing formula. In this manner, PSAs or under at the cap will be treated the same as local school districts with the same foundation allowances, and given the same increases the allowances. Over time, charter schools that were capped below the funding level of the districts in which they are located will catch up to their local districts' funding, and then the funding of both will move together toward the target. Figure 2 below illustrates this occurrence.

[2] Until FY 2002-03, PSAs were capped at $500 above the basic foundation allowance, but the $200 equity payment in FY 2001-02 reduced this cap to $300.

Eventually, if the formula is retained until the target is reached, all charter schools and local school districts that had per-pupil funding below $8,385 in FY 2006-07 will attain the new targeted funding level.

Figure 2



*****Hypothetical foundation allowances based upon hypothetical $200 annual increases in the basic foundation allowance.

A Long Way to Go

Assuming this revived funding formula remains in law, it is unknown how long it will take to reach the new target, since that will depend upon available revenue and the demand for that revenue by other programs. The last time, revenue was booming in the late 1990s, and the target (which was only $800 more than the minimum at that time) was reached in six years. The new target is $1,229 higher than the minimum, or about 50.0% larger, and revenue is not booming. If revenue were large enough to support $100 yearly increases in the basic foundation, it is estimated that it would take 13 years for the minimally funded districts to hit the new target. If revenue boomed and $200 yearly increases were provided, then an estimated seven years would be necessary to reach the new targeted per-pupil funding level.

If the new target is reached, the gap will still be nearly $4,000 per pupil, although, once reached, 90.0% of districts will be at the targeted level of funding. Of course, the Governor and Legislature at any time could enact legislation that changes or eliminates this method of closing the per-pupil funding gap, or could retain the formula. Therefore, time will tell the course of school district funding in Michigan.

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November/December 2007

Michigan State Government Debt
By Gary S. Olson, Director

The Michigan Constitution of 1963 provides the State of Michigan with the ability to raise cash through the issuance of long-term debt. The cash is raised through the issuance of bonds on the capital markets by the State. The debt issued by the Michigan State government falls into two broad categories. General obligation bonds are debt instruments backed by the full faith and credit of the State. Nongeneral obligation bonds are debt instruments backed by dedicated restricted revenue sources.

General obligation bonds are issued pursuant to Sections 15 and 16 of Article IX of the State Constitution. Section 15 authorizes the State to borrow money for specific purposes only after a positive two-thirds vote of the members serving in the House of Representatives and the Senate and a positive vote of the electors in a general election. Section 16 authorizes the State to borrow funds for the purpose of making loans to school districts. These bonds also are backed by the full faith and credit of the State. Current examples in Michigan are bonds issued for environmental cleanup programs and public recreation bonds.

Nongeneral obligation bonds are issued pursuant to Sections 9 and 13 of Article IX of the State Constitution. These sections enable public bodies to issue bonds subject to constitutional restrictions and State law. These bonds are backed by dedicated revenue sources and are not guaranteed by the full faith and credit of the State. Current examples in Michigan are bonds issued by the State Building Authority and the Michigan Housing Development Authority.

This Senate Fiscal Agency (SFA) *State Notes* article provides a summary of the current level of debt issued by the Michigan State government. Included is a discussion of the current types of bonds outstanding and the recent history of the level of debt outstanding. The article also provides a comparison of the level of State debt outstanding in Michigan and in other states. Finally, the article reviews the State budget impact of debt service payments on certain outstanding State bonds.

Michigan Government Debt Outstanding

The State of Michigan had $20.54 billion of debt outstanding on September 30, 2006. This includes general obligation bonds totaling $1.77 billion and nongeneral obligation bonds totaling $18.77 billion. Table 1 provides a summary of the general obligation and nongeneral obligation bonds outstanding on September 30, 2006. In terms of general obligation debt outstanding, bonds issued for loans to school districts totaled $759.9 million or 43.0% of the total general obligation debt outstanding. The remainder of the general obligation debt outstanding consisted of public recreation bonds - $21.1 million; environmental protection bonds - $482.6 million; Clean Michigan Initiative bonds - $449.9 million; and Great Lakes Water Quality bonds - $53.0 million. Michigan voters authorized the public recreation bonds and the environmental protection bonds in November 1988, the Clean Michigan Initiative bonds in November 1998, and the Great Lakes Water Quality bonds in November 2002.

Table 1

Michigan State Government Debt Debt Outstanding as of September 30, 2006 (thousands of dollars)	
General Obligation Debt	
School Loan	$759,935
Public Recreation	21,090
Environmental Protection	482,633
Clean Michigan Initiative	449,966
Great Lakes Water Quality	53,000
Total General Obligation Debt	**$1,766,624**
Nongeneral Obligation Debt	
Michigan Department of Transportation	
Tax Dedicated Bonds	$1,836,104
Grant Anticipation Notes	84,000
Department of Natural Resources	
State Park Revenue Bonds	13,965
Special Authorities-Revenue Bonds and Notes	
Mackinac State Park	1,645
Michigan State Housing Development Authority	1,766,202
Hospital Finance Authority	4,857,896
Michigan Higher Education Facilities Authority	410,875
Michigan Higher Education Student Loan Authority	2,355,400
Michigan Municipal Bond Authority	3,456,474
State Building Authority	3,449,310
Michigan Public Education Facilities Authority	51,800
Michigan Tobacco Settlement Finance Authority	490,501
Total Nongeneral Obligation Debt	**$18,774,172**
Total State Government Debt	**$20,540,796**

Source: Annual Report of the Michigan State Treasurer

The nongeneral obligation debt outstanding of $18.77 billion on September 30, 2006, consisted of debt issued by numerous State agencies and special authorities created by the State. The following information provides a summary of these nongeneral obligation bond issues.

Michigan Department of Transportation Bonds: Article IX, Section 9 of the State Constitution authorizes the issuance of bonds by the Department of Transportation to support transportation projects across the State. The debt service on these bonds is paid from dedicated transportation revenue. As of September 30, 2006, there were $1.92 billion of bonds outstanding.

Michigan State Park Revenue Bonds: The Department of Natural Resources was granted the authority to issue revenue bonds for State parks by Public Act 149 of 1960. The debt service on these bonds is paid from State park-generated revenue. As of September 30, 2006, there were $14.0 million of bonds outstanding.

Mackinac State Park Revenue Bonds: The Mackinac State Park Commission was granted the authority to issue revenue bonds by Public Act 58 of 1995. The debt service on these bonds is paid from revenue generated at the facilities operated by the Mackinac State Park Commission. As of September 30, 2006, there were $1.6 million of bonds outstanding.

Michigan State Housing Development Authority Bonds: The Michigan State Housing Development Authority was created by Public Act 38 of 1969, to issue bonds and notes to finance housing for sale or rental to families with low to moderate incomes and to finance home improvements. The debt service on these bonds is paid from mortgage payments and rental charges from housing projects. As of September 30, 2006, there were $1.77 billion bonds outstanding.

Hospital Finance Authority Bonds: Michigan's State Hospital Finance Authority was created by Public Act 38 of 1969, for the purpose of lending money to nonprofit, nonpublic hospitals and health care corporations. The authority uses the volume of borrowing available to receive lower interest rates that are in turn passed on to the health care corporations. The debt service on these bonds is paid from the loan repayments from hospitals. As of September 30, 2006, there were $4.86 billion of bonds outstanding.

Michigan Higher Education Facilities Authority Bonds: The Michigan Higher Education Facilities Authority was created by Public Act 295 of 1969, for the purpose of assisting private nonprofit institutions of higher education in financing facilities on their campuses. The debt service on these bonds is paid from the loan repayments from colleges. As of September 30, 2006, there were $410.8 million of bonds outstanding.

Michigan Higher Education Student Loan Authority Bonds: The Michigan Higher Education Student Loan Authority was created by Public Act 222 of 1975, for the purpose of making loans to qualified students attending higher educational institutions in the State. The debt service on these bonds is paid from the loan repayments from students once their education is completed. As of September 30, 2006, there were $2.36 billion of bonds outstanding.

Michigan Municipal Bond Authority Bonds: The Michigan Municipal Bond Authority was created by Public Act 227 of 1985, to assist local units of government in reducing their financing costs for public improvements, deficit reductions, and various other municipal purposes. The authority pools the borrowing needs of various local units of government and issues bonds that are used to make loans to local units. The debt service on these bonds is paid from the loan repayments from local units of government. As of September 30, 2006, there were $3.46 billion of bonds outstanding.

State Building Authority Bonds: The State Building Authority was created by Public Act 183 of 1964, to issue bonds to finance the acquisition or renovation of buildings for use by the State or public institutions of higher education. The debt service on these bonds is paid by rental charges levied against the occupants of the buildings. As of September 30, 2006, there were $3.45 billion of bonds outstanding.

Michigan Public Education Facilities Authority Bonds: The Michigan Public Education Facilities Authority was created by Executive Reorganization Order 2002-3, which transferred certain bonding functions of the Michigan Strategic Fund to the new authority. The Authority issues bonds for public school building projects. The debt service on these bonds is paid from the revenue loaned to school districts. As of September 30, 2006, there were $51.8 million of bonds outstanding.

Michigan Tobacco Settlement Finance Authority Bonds: The Michigan Tobacco Settlement Finance Authority was created by Public Act 226 of 2005, for the purpose of making loans and grants to encourage economic development projects in Michigan. The debt service on these bonds is paid from revenue the State is receiving from the 1999 settlement between 46 states and the United States tobacco industry. As of September 30, 2006, there were $490.5 million of bonds outstanding.

Historical Levels of Michigan State Government Debt

The amount of debt held by the Michigan State government has grown considerably in recent years. Table 2 provides a summary of the amount of general obligation and nongeneral obligation State debt outstanding at the close of each fiscal year beginning in FY 1978-79. Total debt outstanding at the close of FY 1978-79 was $2.23 billion. Over the next 27 fiscal years, the level of State debt outstanding increased to $20.54 billion. During this time period, the growth in nongeneral obligation debt exceeded the growth in general obligation debt. In FY 1978-79, general obligation debt accounted for 21.6% of the total State debt outstanding. By FY 2005-06, general obligation debt accounted for only 8.6% of the total State debt outstanding.

In order to analyze the growth in State government debt in recent years, Figure A provides a graphical summary of the growth in State government debt, Michigan personal income, and State appropriations, as measured by State Spending from State Resources, over the period FY 1996-97 through FY 2005-06. Michigan personal income is the best measure available of the growth in the Michigan economy as a whole. Over this 10-fiscal year period, State government debt increased 91.0%, while Michigan personal income increased 37.1% and State Spending from State Resources appropriations increased by 28.5%. The growth in State government debt significantly exceeded the growth in the Michigan economy and State appropriations over this time period.

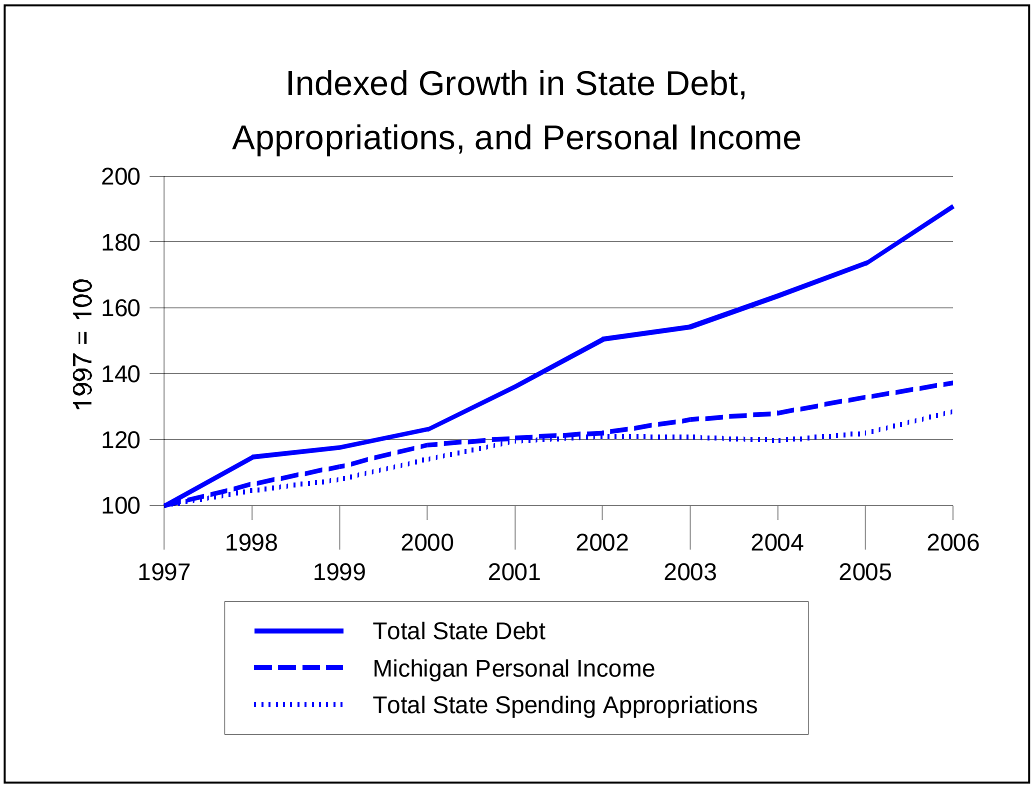
Table 2

Michigan State Government Debt Outstanding
September 30 of Each Year
(dollars in thousands)

Year	State Government Debt: General Obligation	State Government Debt: Nongeneral Obligation	Total State Debt
1979	$482,500	$1,749,940	$2,232,440
1980	439,100	2,353,199	2,792,299
1981	409,600	2,692,335	3,101,935
1982	361,000	3,205,816	3,566,816
1983	309,300	4,059,541	4,368,841
1984	167,300	4,790,151	4,957,451
1985	241,700	4,887,416	5,129,116
1986	198,000	5,601,076	5,799,076
1987	157,700	5,542,242	5,699,942
1988	129,500	5,699,621	5,829,121
1989	106,400	5,777,405	5,883,805
1990	187,723	6,503,638	6,691,361
1991	162,133	7,073,109	7,235,242
1992	402,934	8,305,060	8,707,994
1993	420,813	8,090,423	8,511,236
1994	438,040	8,741,916	9,179,956
1995	706,006	9,192,007	9,898,013
1996	684,983	9,496,680	10,181,663
1997	655,184	10,098,992	10,754,176
1998	874,162	11,459,073	12,333,235
1999	839,377	11,800,972	12,640,349
2000	900,223	12,343,109	13,243,332
2001	998,315	13,664,767	14,663,082
2002	1,081,276	15,088,860	16,170,136
2003	1,371,038	15,198,474	16,569,512
2004	1,497,992	16,089,500	17,587,492
2005	1,617,022	17,054,974	18,671,996
2006	1,766,084	18,774,172	20,540,256

Source: Annual Reports of the State Treasurer

Figure A



Source: Senate Fiscal Agency calculations

State Government Debt in Michigan Compared with Other States

The United States Bureau of the Census publishes annual data regarding the levels of debt outstanding in each state. The Bureau of Census data include both general obligation and nongeneral obligation state debt. In order to provide a meaningful comparison among states, the Bureau of Census data also are published on a per-capita basis.

Table 3 provides the rankings of state debt per capita for the fiscal years 1980, 1990, 2000, and 2005. Over this time period, Michigan moved from a low-ranking state in debt outstanding in FY 1980, ranking 36th, to an above-average state ranking in debt outstanding in FY 2005, ranking 25th. In spite of significant increases in the level of debt outstanding in Michigan from FY 2000 to FY 2005, Michigan's ranking compared with other states fell from 22nd to 25th over this time period.

Table 3

State Rankings of State Debt Per Capita

States	FY 1980	FY 1990	FY 2000	FY 2005
Alabama	39	31	37	44
Alaska	1	1	1	2
Arizona	50	44	49	45
Arkansas	45	41	43	40
California	32	33	31	19
Colorado	46	42	42	23
Connecticut	8	4	4	3
Delaware	4	2	7	7
Florida	38	39	40	42
Georgia	40	47	46	48
Hawaii	2	6	5	9
Idaho	33	34	25	38
Illinois	21	21	16	12
Indiana	49	40	36	30
Iowa	47	43	47	39
Kansas	43	50	48	36
Kentucky	15	17	23	33
Louisiana	17	7	29	26
Maine	19	16	11	13
Maryland	14	18	17	27
Massachusetts	10	5	2	1
Michigan	**36**	**36**	**22**	**25**
Minnesota	25	38	39	43
Mississippi	35	46	41	41
Missouri	42	30	27	20
Montana	27	15	13	11
Nebraska	48	37	44	47
Nevada	18	22	35	46
New Hampshire	11	8	6	6
New Jersey	13	11	10	8
New Mexico	22	24	20	18
New York	6	10	8	5
North Carolina	41	49	38	36
North Dakota	34	20	15	24
Ohio	29	29	33	34
Oklahoma	26	25	32	32
Oregon	3	12	24	17
Pennsylvania	23	35	34	29
Rhode Island	5	3	3	4
South Carolina	20	27	26	16
South Dakota	9	9	12	15
Tennessee	37	45	50	50
Texas	44	48	45	49
Utah	30	28	28	31
Vermont	7	13	9	10
Virginia	31	32	30	28
Washington	28	26	21	22
West Virginia	12	19	19	21
Wisconsin	24	23	18	14
Wyoming	16	14	14	37

Source: United States Bureau of the Census, State Government Finances

Michigan State Budget Impact of Debt

The majority of the debt service payments on State debt outstanding do not show up directly in the State budget. Most of the repayment of State debt outstanding in Michigan is paid by educational institutions, local units of government, and hospitals for which the borrowing is undertaken. These repayments do not involve direct State appropriations.

The most direct impact on the State budget of debt service costs results from the repayment of general obligation bonds and bonds issued by the State Building Authority. These debt service payments are made primarily from General Fund/General Purpose appropriations and from a small amount of Federal and State Restricted funds. Table 4 provides a historical review of debt service appropriations on State Building Authority and general obligation bonds by fiscal year for the period FY 1994-95 through FY 2007-08. During FY 2007-08, debt service appropriations on bonds issued by the State Building Authority total $226.8 million and debt service appropriations on general obligation bonds total $120.0 million.

Table 4

Debt Service Gross Appropriations (millions of dollars)

Fiscal Year	State Building Authority	General Obligation Bonds	Total
1994-95	$156.9	$43.0	$199.9
1995-96	166.8	40.1	206.9
1996-97	205.3	64.2	269.5
1997-98	241.7	64.2	305.9
1998-99	232.2	94.1	326.3
1999-00	252.6	94.1	346.7
2000-01	276.9	91.6	368.5
2001-02	265.6	97.0	362.6
2002-03	291.3	59.6	350.9
2003-04	242.7	56.3	299.0
2004-05	250.8	81.5	332.3
205-06	253.7	89.0	342.7
2006-07	237.3	100.2	337.5
2007-08	226.8	120.0	346.8

Source: Senate Fiscal Agency

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Predatory Lending
By Craig Laurie, Legislative Analyst

Though not defined in Michigan or Federal law, predatory lending typically involves harmful or fraudulent sales tactics as well as abusive loan terms and practices perpetrated primarily by mortgage brokers and lenders, and sometimes real estate appraisers, at the expense of mortgage loan applicants and borrowers. At particular risk are borrowers and loan applicants who do not have access to the prime market and are subprime borrowers. The subprime market consists of borrowers who do not qualify for prime or best lending rates or who qualify only for risky nontraditional loans with adjustable rates and interest-only payment options because of their deficient credit history.

Below is a brief overview of a few specific types of predatory lending, legislation and regulations that could be implemented in Michigan, and examples of potential State intervention.

At-Risk Consumers

Although predatory lending can occur in virtually any lending market, subprime borrowers are especially vulnerable to the fraudulent or deceptive lending practices and unfair or extreme loan terms that comprise predatory lending.[1] Subprime borrowers usually are those who cannot qualify for traditional mortgages with competitive interest rates and fees, due to poor credit histories or adverse financial situations. Because of targeted predatory lending practices and borrowers' lack of knowledge about mortgages and lending, even some borrowers who might qualify for prime loans end up in the subprime market. The problem in Michigan, however, extends beyond the subprime market, as indicated by mortgage payment delinquency rates in the State that are approximately double the national average in all mortgage loan categories.[2] Because of the complexity of nontraditional loans, including interest-only and adjustable rate mortgages, people who take out these loans also may be subjected to predatory lending practices.

Predatory lenders often target certain demographic populations, including the elderly, racial and ethnic minorities, and borrowers with little knowledge of mortgage or finance. According to *Curbing Predatory Home Mortgage Lending*, a joint report by the U.S. Department of Treasury and U.S. Department of Housing and Urban Development (HUD), when controlling for income, people who live in predominantly African-American communities refinance using subprime markets much more often than do residents of predominantly white communities.

Types of Predatory Lending

While the Federal government has been primarily responsible for laws pertaining to disclosures about fees that mortgage brokers must make to borrowers, states tend to regulate mortgage broker, lender, and appraiser practices.[3] States have the ability to make significant changes in

[1] "Curbing Predatory Home Mortgage Lending: A Joint Report National Predatory Lending Task Force", HUD and U.S. Department of Treasury, June 2001.
[2] Pollock, Alex J., "The Subprime Bust and the One-Page Mortgage Disclosure", submitted to the Senate Committee on Banking and Financial Institutions, 11-28-07.
[3] "Curbing Predatory Home Mortgage Lending".

the way that principal actors behave in the lending process, specifically in instances in which a broker, lender, or appraiser intentionally deceives a borrower or obscures the lending process in order to take advantage of a borrower.

Loan Flipping. Throughout the course of a mortgage, a borrower may refinance for several purposes, including to secure a lower interest rate or consolidate debt. In order to receive tangible benefits such as a lower interest rate, or the ability to meet scheduled payments, a borrower can expect to be charged an origination fee on any new principal added to the loan through refinancing.

Loan flipping occurs when a lender encourages a borrower to refinance his or her loan even though the borrower would receive no real benefit from doing so. Instead of charging origination fees on additional principal only, loan flipping lenders may charge high fees on the entire amount of the loan, effectively recharging a borrower for the same loan and diminishing any equity in the home.

Loan flipping is not prohibited in Michigan. As noted below in Table 1 (which identifies predatory lending loans in Michigan and six neighboring states), Illinois, Kentucky, Minnesota, Ohio, and Wisconsin ban the practice, as do several other states. Some people believe that prohibiting the practice can save many borrowers from outright fraud as loan flipping, by definition, has no conceivable benefits for the borrower. It also has been suggested that any legislation banning loan flipping should be specifically targeted to the practice, as overly strict or broad prohibitions or restrictions on certain lending fees and practices could be detrimental to legitimate refinancing that is beneficial to a borrower.[4] For example, legislation in Minnesota prohibits "churning", which means "knowingly or intentionally making, providing, or arranging for a residential mortgage loan when the new residential mortgage loan does not provide a reasonable, tangible net benefit to the borrower considering all of the circumstances including the terms of both the new and refinanced loans, the cost of the new loan, and the borrower's circumstances".[5]

Disregard for a Borrower's Ability to Repay. A borrower's credit history and job stability are important factors used by a lender to determine the borrower's ability to repay a loan and the conditions of that loan. When assessing the eligibility of a potential borrower, a broker or lender should evaluate the borrower's ability to pay the loan using liquid assets, including income. Asset-based lending, on the other hand, occurs when a lender decides whether to make a loan based on nonliquid sources of value, specifically a house. In addition, some brokers base loan decisions on "stated income" without verification and without regard to taxes and other general living expenses.

According to the National Conference of State Legislatures, debt-to-income ratio is a good indicator of the ability to repay a loan. Requiring a lender or broker to give "due regard" to this ratio, or specifying a ratio that a borrower must meet, protects against asset-based lending and increases the likelihood that a borrower will repay a loan.

[4] "Curbing Predatory Home Mortgage Lending".
[5] Chapter 18, Section 23 of the Laws of Minnesota.

In Michigan, a lender is not required to consider the debt-to-income ratio of a prospective borrower and there otherwise is little to prevent a lender from making a loan to a borrower who does not have the ability to repay. Debt-to-income ratio provisions have been added to state laws in Illinois, Indiana, Kentucky, Minnesota, Ohio, Wisconsin, and several other states. Some states, including Illinois, Kentucky, and Ohio, establish a presumption at 50.0% (debt to income) while others require a lender to verify the ratio of a potential borrower or to give it due regard.

Recently, the Federal Reserve Board proposed new rules and restrictions designed to eliminate mortgage loans to borrowers who obviously have no ability to pay. According to the rules, a broker or lender would have to verify and document a borrower's ability to repay a loan and demonstrate that future changes in payments would be covered by the projected income of a borrower.[6] It is unclear what effect the rules, if adopted, will have on predatory lending practices.

Expedited Services. A borrower's lack of understanding of a loan or the mortgage process may be compounded by quick transactions and a flood of information. Because of the complicated nature of mortgages, borrowers often are misinformed about the details of a loan, either intentionally or otherwise, and sometimes are under the impression that quickly agreeing to the terms of a mortgage is necessary. Furthermore, a broker might indicate that a mortgage is available only for a limited time and that extended consideration of the consequences of borrowing could be detrimental to the borrower. Some people believe that prescribed waiting periods after loan applications, in combination with mandatory credit counseling, could minimize the opportunity for lenders to take advantage of rushed decisions and misunderstood loan terms.

Coerced/Inflated Appraisals. Some mortgage lenders make an appraisal job contingent on a preconditioned outcome of the appraisal, request that an appraiser review an undesirable appraised value, threaten to take future business to other appraisers if a predetermined appraised value is not met, or refuse to pay for appraisal services already rendered when a requested appraised value is not returned. Even though many appraisers strongly oppose coerced and inflated appraisals, reportedly it can be difficult to work as an appraiser in the current real estate market without acquiescing to the suggestions or demands of mortgage lenders. Inflated appraisals can exacerbate the burden on a borrower by creating a debt that is more than his or her property is actually worth.

In Michigan, Senate Bills 342, 343, and 356 were introduced to address certain appraisal practices, specifically the inflation of an appraisal. Supporters of the bills believe that they would help to eliminate appraiser and lender misconduct in Michigan, and would enable appraisers to oppose the practice of inflating appraisals without fear of reprisal. (The bills have passed the Senate and been referred to the House Committee on Banking and Financial Services. A more detailed analysis of the bills is available at www.legislature.mi.gov.)

Prepayment Penalties. Many subprime and nontraditional mortgage products contain prepayment penalty clauses that charge the borrower a fee for paying off a mortgage before the term of the loan has ended. Prepayment penalties prevent borrowers from accelerating the payment of their loans and from refinancing loans at lower rates.

[6] Andrews, Edmund L., "In Reversal, Fed Approves Plan to Curb Risky Lending", *New York Times Online*, 12-19-07.

Prepayment penalties are legal in Michigan and, when offered transparently, allow brokers and lenders to protect profits in risky markets. Prepayment penalties are problematic when they are not clearly disclosed to the borrower or when they are in excessive amounts.

As of July 26, 2007, six states and the District of Columbia had banned prepayment penalties.

Balloon Payments. A balloon payment covers the remaining principal at the end of a loan, which must be paid off in one lump sum. Evidently, balloon payments are frequently large enough that a borrower must apply for a new loan to make the balloon payment. As with prepayment penalties, balloon payments are legal components of loan packages, but can present a problem if the borrower does not completely understand the tradeoffs being made.

Table 1
Predatory Lending Laws

	Flipping Banned	Prepayment Penalties/Fees Banned	Debt to Income Ratio Provision	Consumer Credit Counseling Provision
Michigan	**No**	**No**	**No**	**Notification**
Illinois	Yes	No[1)]	Yes	Notification
Indiana	No	No	Yes	Third Party Required
Kentucky	Yes	No[1)]	Yes	Notification
Minnesota	Yes	No	Yes	Notification[2)]
Ohio	Yes	No	Yes	No
Wisconsin	Yes	No	Yes	Notification

[1)] A bill was introduced in 2007 to ban prepayment penalties/fees in certain situations.
[2)] A bill was introduced in 2007 to require credit counseling in certain situations.

Source: The National Conference of State Legislatures (http://www.ncsl.org/programs/banking/bankmenu.htm)

Potential Intervention

Broker/Lender Regulation. In addition to adopting the measures described above, Michigan could prioritize the enforcement of current consumer protection and other laws prohibiting aggressive and fraudulent sales practices, and aim to eliminate brokers and lenders who intentionally mislead or defraud borrowers. Senate Bills 826 through 833, along with House Bills 5287 through 5291, would create the Mortgage Industry Advisory Board, require the registration of mortgage loan officers, establish continuing education requirements for loan officers, prohibit loan officers from engaging in fraud, deceit, or material misrepresentation, and extend administrative and criminal penalties to loan officers who violated the law. Some people believe that the bills would address the problem of predatory lending by increasing the professionalism on the broker side of a loan and minimizing the access of bad actors to an already volatile market. (Senate Bills 826 through 833 have passed the Senate and, like the House bills, have been referred to the House Committee on Banking and Financial Services. A more detailed description of the bills is available at www.legislature.mi.gov.)

One-Page Mortgage Disclosure. Another basic tool that could be used to increase borrowers' understanding of their mortgages and transparency in the broker and lending processes is the one-page mortgage disclosure.[7] The disclosure would contain key information about a mortgage, including the amount, type, duration, and fully indexed rate of the loan as well as prepayment fees, indicate balloon payments, and identify potential rate adjustments. The disclosure also would state clearly the monthly income on which the loan was based and the relationship between the amount of the loan and the actual appraised value of the property. At the very least, the disclosure would illustrate the big picture of the loan to the borrower and provide the transparency that is lacking in some mortgage transactions.

Though not limited to one page, a mortgage application form containing "The Basic Facts About Your Mortgage Loan" would be required in Michigan by Senate Bill 924. (That bill has been referred to the Senate Committee on Banking and Financial Institutions.)

Consumer Credit Counseling. Compared with an uninformed borrower, an educated borrower has a better chance of getting a fair and affordable mortgage. Some states require that borrowers receive credit counseling or other information about the risks involved in borrowing and the options available to them. Many states, including Michigan, require lenders to provide loan applicants with a written notice regarding the value of receiving credit counseling before taking out a mortgage loan. It has been suggested that by requiring subprime and nontraditional loan applicants actually to receive credit counseling, the State could protect borrowers from predatory lending without restricting the types of loans available to them and without eliminating products offered by brokers and lenders.

Conclusion

Nontraditional mortgages, including those in the subprime market and adjustable rate mortgages in both the subprime and prime markets, can be valid tools to help borrowers purchase houses. To protect borrowers, however, the law could require mortgage transactions to be transparent while ensuring that the products are available only to qualified candidates.

For more information on predatory lending in the United States, please see *Curbing Predatory Home Mortgage Lending*, the joint report by HUD and the U.S. Department of Treasury.

[7] Pollock, Alex J.

State Notes

TOPICS OF LEGISLATIVE INTEREST

November/December 2007

Divestiture of State Funds from Businesses Associated with State Sponsors of Terror
By Stephanie Yu, Fiscal Analyst

Divestment Legislation

Throughout the United States, various states have enacted or are considering legislation to require the divestment of state funds from various countries, most notably Sudan. In Michigan, proposed legislation would require the divestment of State funds from all "state sponsors of terror" as identified by the U.S. Department of State. Currently, that list includes Sudan, Iran, North Korea, Syria, and Cuba. There are several proposals before the Michigan Legislature that target different countries and vary in breadth, timeline, and strictness.

Senate Joint Resolution J (SJR J) would amend the State Constitution to prohibit any public body, including public universities, from investing in any company doing business in or with state sponsors of terror. Senate Bills 846 through 856 would prohibit the investment of State funds in companies engaging in business with known state sponsors of terror. The bills also would establish a gradual divestment schedule, requiring that all funds be divested from such investments within 15 months. Funds affected would include the four major State pension funds (the Michigan State Employees' Retirement System (MSERS), Michigan Public School Employees' Retirement System (MPSERS), Michigan State Police Retirement System (MSPRS), and Michigan Judges' Retirement System (MJRS)) as well as the Michigan Education Trust Fund, State surplus funds, and community colleges' funds.

Senate Bill 555 as introduced addresses divestment from companies with active business operations in Sudan. That bill would require divestment within nine months, following an investigation and written notices to the companies involved. Several other states are considering similar proposals, although the scope of those proposals varies greatly. Florida recently enacted legislation requiring divestment from Sudan and any company with investments of more than $20.0 million in Iran's energy sector. Ohio recently came to a compromise for state pension funds voluntarily to divest themselves of Iran energy-related holdings without legislation. California enacted a bill requiring the state pension funds to eliminate any Iran-related investments.

The Michigan Department of Treasury has indicated that there are considerably more State investments in Iran than in Sudan, and broadening the divestment requirement to additional countries would increase the costs of implementation. The current legislation is summarized in Table 1.

South Africa

In the late 1980s, a similar movement swept through state legislatures in regard to South Africa. Michigan passed divestiture legislation with a five-year implementation program. The program was abandoned after the third year, as apartheid had ended and investment in that country was once again encouraged. However, some would argue that this movement, which included both public and private investments, contributed to the end of apartheid.

Table 1

Pending Michigan Legislation on Divestment		
Bill Number	**Content**	**Status**
SJR J	Would amend the State Constitution to prohibit investment in companies doing business with state sponsors of terror	Pending before the whole Senate
SB 555	Would require the State to divest State funds in any Sudanese business or interest	Referred to Senate Appropriations Committee
SB 846	Would require various State funds to divest from certain companies with business operations in state sponsors of terror	Pending before the whole Senate; tie-barred to H.B. 4854 and 4903
SB 847-856	Would require various State funds (pensions, trust funds, community colleges, et al.) to comply with the terms of S.B. 846	Pending before the whole Senate; tie-barred to H.B. 4854 and 4903
HB 4854	Would require the various State retirement systems to divest from certain companies invested in Sudan	Passed the House, referred to Senate Appropriations Committee
HB 4903	Would require the various State retirement systems to divest from certain companies invested in Iran	Passed the House, referred to Senate Appropriations Committee
HB 4904	Would prohibit the State Treasurer from depositing surplus funds in certain financial institutions that knowingly make or maintain loans to Iran, North Korea, Sudan, or the Syrian Arab Republic, its national corporations, or subsidiaries or affiliates of U.S. firms operating in those countries	Referred to House Committee on Government Operations
HB 4969	Would prohibit the Department of Management and Budget and State agencies from entering into contracts with a vendor or supplier who conducts business in or with the Republic of Sudan	Referred to House Committee on Government Operations
HB 5095	Would prohibit the State Treasurer from depositing surplus funds in certain financial institutions that knowingly make or maintain loans to oppressive regimes, national corporations of oppressive regimes or subsidiaries or affiliates of U.S. firms operating in those countries	Referred to House Committee on Government Operations

Sudan Divestment Legislation

There are a number of states that either have enacted or are considering legislation requiring divestment from state sponsors of terror, most notably Sudan. As of December 2007, 12 states had passed laws requiring divestment from Sudan, four states had legislation pending, four states had voluntarily divested certain holdings, and three states had failed to pass proposed measures. The U.S. Congress also has passed legislation that allows states to divest from Sudan, but President Bush has not signed it. There are some concerns at both the state and Federal levels that these proposals blur the lines between state and Federal jurisdiction. The Bush administration has stated publicly that it does not support these types of proposals. In Michigan, the Department of Treasury has voiced concern about states' engaging in foreign policy decisions. An additional concern is the process for identifying state sponsors of terror.

While the U.S. Department of State identifies certain countries as being involved in terror activity, the list is subject to change, and creating a clear-cut definition of which countries were permissible investments would be difficult. Table 2 below from the Sudan Divestment Task Force summarizes initiatives across the United States.

Table 2

Targeted Sudan Divestment Legislative Chart

State	Bill	Status	Notes
California	AB 2941	Signed by Governor Arnold Schwarzenegger (9/25/06)	Passed
Colorado	HB 1184	Signed by Governor Bill Ritter (4/19/07)	Passed Endorsed by Public Employees' Retirement Association of Colorado (PERA)
Florida	SB 2142	Signed by Governor Charlie Crist (6/8/07)	Passed
Hawaii	HB 34	Signed by Lt. Governor Duke Aiona (6/18/07)	Passed
Indiana	HB 1484	Signed by Governor Mitch Daniels (5/3/07)	Passed
Iowa	SF 361	Signed by Governor Chet Culver (4/5/07)	Passed
Kansas	SB 2457	Signed by Governor Kathleen Sebelius (5/11/07)	Passed
Maryland	SB 344	Withdrawn	Alternative legislation passed; prohibits future investments and recommends divestment
Massachusetts	S2255	Signed by Governor Deval Patrick (11/2/07)	Passed
Michigan	SB 0555, HB 4854	SB 0555: Assigned to Senate Appropriations Committee HB 4854: Passed House Chamber; Assigned to Senate Appropriations	
Minnesota	SF1075	Signed by Governor Tim Pawlenty (5/23/07)	Passed
Nevada	*No Legislation Filed*		Governor Jim Gibbons and legislative leadership have urged the state pension fund (PERS) to voluntarily adopt a targeted Sudan divestment policy

New Mexico	*No Legislation Filed*	State Investment Officer Gary Bland, at the behest of Governor Bill Richardson, ordered the State Investment Council to divest the New Mexico Permanent Fund (11/9/07) New Mexico Educational Retirement has also divested (12/8/07)	Follows Sudan Divestment Task Force model of targeted Sudan divestment The Public Employees Retirement Association of New Mexico has not adopted a Sudan divestment policy.
New York	*Legislation Not Needed; Session Ended*	New York State Comptroller, Thomas P. DiNapoli, adopted a targeted Sudan divestment policy for the New York State Common Retirement Fund (6/11/07)	Follows Sudan Divestment Task Force model of targeted Sudan divestment
North Carolina	HB 291	Signed by Governor Mike Easley (8/31/07)	Passed
Ohio	SB 161	Assigned to Senate Committee on Finance	
Pennsylvania	HB 1140	Passed House Chamber; now heads to Senate Chamber	
Rhode Island	H 5142, S 87	Signed by Governor Donald Carcieri (6/22/07)	Passed
South Carolina	SB 241	Failed to Pass	Based off California divestment statute
Texas	SB 247	Signed by Governor Rick Perry (6/15/07)	Passed
Vermont	*Legislation Not Needed*	Vermont State Treasurer, Jeb Spaulding, adopted a targeted Sudan divestment policy (2/26/07)	Follows Sudan Divestment Task Force model of targeted Sudan divestment
Virginia	SB 1331, HB 1828	SB 1331: Failed to Pass HB 1828: Failed to Pass	
Wisconsin	AB 124, SB 57	AB 124: Assigned to House Committee on Financial Institutions SB 57: Assigned to Senate Committee on Veterans and Military Affairs, Biotechnology and Financial Institutions	
Federal	S 2271	Passed Congress; now heads to President	Authorizes and encourages state level Sudan divestment, places restrictions on Federal contracts for offending companies operating in Sudan

Source: http://sudandivestment.org/home.asp

National Foreign Trade Council* v *Giannoulias

At different times, states have proposed divesting from certain countries, including South Africa and Burma, for political reasons. However, those restrictions have come under scrutiny from the courts, questioning whether such measures encroach on the jurisdiction of the Federal government. In the case of divestment from Sudan, legislation passed in January 2006 in Illinois has been the target of a lawsuit brought by the National Foreign Trade Council (NFTC). In *National Foreign Trade Council* v *Giannoulias*, the NFTC claimed that the law violated the U.S. Constitution and interfered with the Federal government's foreign affairs power, specifically Article VI, Clause 2 of the U.S. Constitution, which reads:

> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

The U.S. District Court sided with the NFTC in the case in February 2007, and the state of Illinois may appeal or alter the law to address the concerns of the court.

Michigan Senate Bill 846 (S-1) states that if any provision of the legislation is found to be unconstitutional or otherwise illegal, the provision is severable from the remainder of the act. Also, fiduciaries that complied with the legislation would be immune from liability. Michigan House Bill 4903 contains language stating that if the Congress or President of the U.S. finds that the legislation "interferes with the conduct of United States foreign policy", the legislation is no longer valid.

Fiscal Impact

The various measures proposed in Michigan would have an indeterminate fiscal impact on the State and local units of government. Senate Joint Resolution J would amend the State Constitution to prohibit any public body, including public universities, from investing in any company doing business in or with state sponsors of terror, as determined by the U.S. Secretary of State. Senate Bill 846 (S-1) would prohibit the fiduciaries for various State entities from maintaining investments in or investing in companies with business operations or direct or indirect investments in state sponsors of terror, subject to certain threshold amounts an exemption for companies providing humanitarian aid. These entities include the retirement systems of the Michigan Legislature, the State Police, judges, State employees and public school employees, as well as the fiduciaries for the 21st Century Jobs Trust Fund, the Veterans' Trust Fund, the Children's Trust Fund, surplus funds in Treasury, the State Lottery, community colleges, the Environmental Protection Fund, the Michigan Education Trust, and the Michigan Strategic Fund. The remaining bills simply would update the individual acts pertaining to these entities to require compliance with Senate Bill 846.

While it is difficult to quantify the precise fiscal impact of these bills on State government, it could be substantial. The Department of Treasury has indicated that not only would there be immediate transaction costs involved in the divestiture, there would be compliance costs going forward as well. Currently, the Bureau of Investments does not have employees dedicated to compliance with legislative restrictions, but several would be necessary under these bills. Transaction costs are typically paid out of the funds, and are not subject to the appropriations process, but the cost of additional staff would need to be included in the Treasury Department's budget. According to the Department, transaction costs could be considerable, particularly because these funds often invest in indices and mutual funds that contain many companies, which would make singling out individual companies difficult. In addition to these more measurable costs, the Department predicts that the opportunity costs of prohibited investments could be high, thereby affecting the overall value of State funds; however, these potential costs or gains can only be determined retrospectively. The Department also is concerned that injecting political motives into the investment process could hinder that process; and restricting permissible investments would undermine the mission of the Bureau of Investments, which is to maximize the value of its investments in a fiscally responsible way.

The Department of Treasury has focused on the impact of these bills with respect to the Department's investments, which would not include all of the entities in the resolution and bills. For the Department's investments alone, Treasury has estimated that it would cost approximately $30,000 per year per country to ensure compliance with the proposed restrictions. That amount would cover the cost of hiring a private company to monitor compliance, and would be ongoing. That number could be slightly lower for countries where the State has smaller investments.

The potential fiscal impact on universities, community colleges, local units of government, and other public bodies is difficult to determine, as it depends on the amount each entity has invested in relevant companies. Senate Joint Resolution J would require that each public body report to the Department annually. While the resolution does not specify the Department's responsibility, if the Department of Treasury were charged with compiling a list of companies for each country and assisting public bodies with compliance, the Department would incur significant additional costs.

As of September 30, 2006, MSERS, MPSERS, MSPRS, and MJRS had combined total assets of approximately $64.0 billion.